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FM AMEMBASSY MOSCOW  
TO RUEHC/SECSTATE WASHDC PRIORITY 9379  
INFO RUEHHD/MOSCOW POLITICAL COLLECTIVE PRIORITY  
RHEHNSC/NSC WASHDC PRIORITY  
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY

C O N F I D E N T I A L MOSCOW 002316

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STATE FOR EUR/RUS; NSC FOR MWARLICK

E.O. 12958: DECL: 08/08/2018

TAGS: ECON EINV ETRD PREL PGOV RS

SUBJECT: MINFIN OFFICIAL ON KUDRIN RUMORS, INVESTMENT CLIMATE, WTO ACCESSION

Classified By: Minister Counselor for Economic Affairs Eric Schultz for Reasons 1.5 (b) and (d).

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Summary  
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¶1. (C) In an August 6 meeting with ECMIN, Finance Minister's Kudrin, s Assistant, Vadim Grishin, dismissed rumors of Kudrin's impending departure, which he said were the result of sharp internal GOR budget negotiations. He said Kudrin had arranged a delay in the BONY case, providing time for a compromise to be negotiated, but added that the Finance Ministry had no authority to intervene in the TNK-BP dispute, which he acknowledged had affected investor confidence. Grishin said the GOR had also mishandled the Mechel case, further depressing the markets and weakening the economy. However, the Finance Ministry saw a silver lining in the form of slower growth, which could help cool the economy and reduce inflation. Grishin said he was increasingly pessimistic about the chances of WTO accession for Russia this year and said failure could have global consequences.  
End Summary.

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Tough Internal GOR Negotiations  
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¶2. (C) Grishin acknowledged that rumors Kudrin might be on his way out were gathering steam. However, Grishin said there was no substance to the rumors. They were being spread by Kudrin's opponents within the GOR. Grishin noted that these rumors peaked at about this time very year, when the GOR was negotiating the annual budget. Kudrin's job was to try to hold the line on public spending and his efforts to impose fiscal discipline put him at odds with many of the other ministries. Grishin added that while there might be some small changes to the cabinet in the fall, he did not expect any major changes, especially to the economic ministries given the current uncertain global financial environment.

¶3. (C) Grishin said one of the most contentious disputes on going within the GOR was over a reduction in the VAT. Kudrin strongly opposed a cut, arguing that that it would make the government budget more dependent on oil and gas taxes and therefore subject to the tremendous price volatility in that sector. Kudrin also believed that the problem with VAT was not the rate but the government's administration of the tax. There were too many loopholes, which allowed excessive rebates to companies and individuals and reduced government revenue. The Presidential Administration favored a substantial cut, especially Presidential Assistant Dvorkovich, in order to stimulate faster and better economic growth. Dvorkovich's former assistant, now Deputy Economic

Minister, Voskresensky also strongly favored a cut in the VAT but his Minister, Nabiullina, was more cautious and was trying to broker a compromise proposal.

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BONY/TNK-BP  
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¶ 14. (C) Grishin said Kudrin had personally intervened in the Federal Customs Service (FCS) case against the Bank of New York (BONY) to secure a postponement until October 6. Kudrin hoped, according to Grishin, that the two sides would use the hiatus to negotiate a resolution of the case. BONY Officials had undoubtedly been involved in some shady dealings in the 1990s in Russia and had admitted as much in the U.S. case against them. However, the Finance Ministry did not believe it was in Russia's best interests for this case to be decided in a Russian court, especially if the court relies on the U.S. RICO statute to make a decision.

¶ 15. (C) ECMIN asked whether the same logic did not apply to the TNK-BP dispute. Grishin responded that the Finance Ministry had made its views on the case known; that the dispute was hurting Russia economically. However, it was not his Minister's area of responsibility. Deputy Prime Minister Sechin was overseeing the case.

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Mechel  
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¶ 16. (C) Grishin explained that the GOR had also erred on Mechel. Again, there was no question that there was a case

to be answered by Mechel's management over their use of transfer pricing to evade taxes. However, the GOR was still learning how to manage an economy in which the stock market was a major player. The public attacks had been a mistake, causing an unexpected downturn in the stock market, which in turn was hurting the overall economy. Grishin stressed that it was not a "political process" but a legal one. Still, he expressed hope that the GOR would learn from this incident and be more careful in the future over market reactions.

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Inflation  
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¶ 17. (C) Grishin added that, perhaps counter-intuitively, the Finance Ministry saw an upside in the market's reaction to Mechel since it was anti-cyclical and was helping to cool the overheating economy. In that regard, Grishin acknowledged that Russia might be nearing the end of the current business cycle. Slowing economic growth was likely, and that might be the best way to reduce inflation. While inflation had softened from June to July, this reflected a seasonal weakening of demand rather than any lasting downturn driven by policy shifts. In fact, Grishin noted, the GOR had weak tools to fight inflation and if the VAT was cut the resulting stimulus was likely to exacerbate inflation even further, another reason Kudrin opposed the cut.

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WTO Accession  
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¶ 18. (C) Grishin said he would rate the chances of Russia acceding to the WTO this year at less than 50 percent. September and October would be the last chance to make it this happen this year. However, momentum was slowing and we appeared to have hit a spot where countries were adding more new items to the agenda than were being struck off by the negotiators. In that regard, he pointed to the absence of an agreement with the U.S. on state-owned enterprises (SOEs), which had opened the door for Saudi Arabia and others to raise this issue in Geneva.

¶ 19. (C) Grishin said failure this year would greatly

strengthen the hand of the domestic opponents of WTO accession. Emboldened critics in the Agriculture Ministry and elsewhere would press for more protectionist measures. Grishin added that the Finance Ministry's view was that Russia's failure to accede, the last large economy outside the WTO, coming on the heels of the failure of the Doha round, would also undermine the WTO internationally.

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Comment  
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¶10. (C) The Russian economy has hit a rough patch, the most visible symbols of which are high inflation and the precipitous drop in the stock market. Growth remains strong but investor confidence is down and risk premiums are rising.

Most analysts, economists and businessmen with whom we talk believe that the GOR is capable of managing a downturn in the business cycle, provided Kudrin remains at the Finance Ministry. However, if his opponents succeed in dragging him down, the resulting reduction in economic confidence is likely to be substantial.

RUBIN